

QUARTERLY REPORT



OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan
County Executive

Bruce Romer
Chief Administrative Officer

May 22, 2006

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended March 31, 2006. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were an estimated 5,470 active members and 4,770 retirees participating in the ERS as of March 31, 2006.

Performance Results

The total return achieved by the ERS assets for the quarter was 4.33%, 37 basis points ahead of the 3.96% return of the policy benchmark. For the one year period ending March 31, the ERS' gross return (before fees) was 13.12%, 61bps. ahead of the 12.51% return of the policy benchmark. The strong one-year return places the ERS' performance in the top 36% of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was 16.66%, after fees, ranking in the top 17% of the universe. The asset allocation at March 31, 2006 was: Domestic Equities 49.3%, International Equities 17.2%, Fixed Income 22.7%, Inflation Linked Bonds 9.2%, Alternative Investments 1.5% and Cash 0.1%.

Major Initiatives

During the quarter, the Board conducted a search for real estate managers which resulted in the selection of two firms, who will manage a total of 5% of the System's assets.

Other actions by the Board included: evaluation of our strategic asset allocation/manager funding policies resulting in rebalancing funds between active and passive domestic equity managers, jointly issuing a Request for Proposal with the County Attorney's Office for outside legal counsel, reviewing the fiduciary insurance policy and indemnification provisions, exploring the use of enhanced index products, and continuing work on the risk management program.

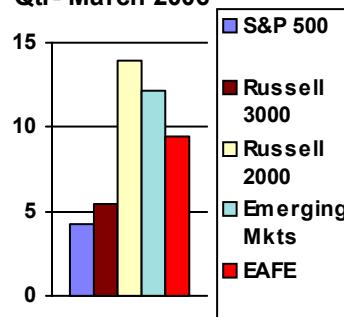
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Capital Markets and Economic Conditions

During the first quarter, GDP growth was significantly higher than the 1.7% pace of the last quarter of 2005, which was the slowest quarterly growth rate in three years. Strong consumer spending provided a solid foundation for economic growth. Unemployment and inflation remain under control. However, potential inflationary impacts from high energy prices and an unemployment rate approaching its structural limit have convinced the Federal Reserve that inflation remains a key risk to the economy. The Fed raised interest rates twice in the quarter, on January 31 and March 30, and most economists believe that the Fed will likely raise rates to 5% at its next meeting in May.

As shown in the chart to the right, the U.S. equity markets moved higher during the quarter with the broad indices, with the small capitalization companies represented by the Russell 2000 Index producing the strongest performance, up nearly 14%. In comparison, the S&P 500 Index gained 4.2%. The top performing sector of the S&P 500 during the quarter was telecommunications with the performance driven by Verizon, BellSouth, and AT&T. Energy, industrial and material stocks did particularly well, reflecting investors' views that the economy is still growing. Underperforming sectors included utilities and financial services both of which tend to suffer more because they are more interest-rate dependent. Google was added to the S&P 500 Index at quarter ending ranking in the top 30 stocks by market capitalization.

**Index Returns
Qtr- March 2006**



Our combined domestic equity performance was a gain of 5.47%, 16 basis points ahead of the Russell 3000 benchmark index return. For the one year period ending March 31, our combined domestic equity performance was 15.22%, over 90 basis points ahead of the 14.28% return achieved by the Russell 3000 benchmark index.

Within the international markets, the emerging markets sector provided the strongest performance, up 12.12% for the quarter and 47.98% for the one year period. China and Latin American markets did well during the quarter. China's new five-year plan focusing on multiyear infrastructure projects should benefit capital good exporters. Developed international markets were up 9.40% for the quarter as measured by the MSCI EAFE Index. Our combined international equity performance was a gain of 10.35% for the quarter, 59 basis points ahead of the benchmark index return of 9.76%.

Most fixed income markets recorded negative returns for the quarter due to rising real yields. Rising real rates occur in growing economies, reflecting increasing demand for capital. The high yield market was the only market to achieve positive performance, up nearly 3% for the quarter, supported by a low default rate, solid balance sheets, strong corporate earnings and a steady economy. Our combined fixed income return for the quarter was a 0.21% compared to the 0.20% return recorded by the benchmark index. ERS investments in inflation-linked bonds recorded a loss of 1.06% for the quarter compared to the benchmark loss of 1.86%. The inflation numbers released during the quarter, and rising real yields across the globe, caused prices for the longer-dated maturities of inflation-linked securities to fall globally, including the TIPS market. The only exception was the Australian index which managed to generate a slightly positive return.

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Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending March 31, 2006 and fiscal year-to-date.

Employees' Retirement System Contributions and Investment Income (millions)

	<u>Qtr 03/31/06</u>	<u>Fiscal YTD</u>
Employer Contributions	\$ 22.1	\$ 66.2
Member Contributions	4.0	12.2
Net Investment Income	<u>93.6</u>	<u>215.0</u>
	<u>\$ 119.7</u>	<u>\$293.4</u>

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

Employees' Retirement System Deductions by Type (millions)

	<u>QTR 03/31/06</u>	<u>Fiscal YTD</u>
Benefits	\$ 31.7	\$ 93.4
Refunds	.1	.4
Administrative Expenses	.4	1.4
	<u>\$ 32.2</u>	<u>\$ 95.2</u>

Outlook

Strong economic indicators suggest that the Federal Reserve will continue tightening at its next two Federal Open Market Committee (FOMC) meetings. Because of the weakening in residential investment and housing markets, GDP growth will slow as the next few quarters unfold. This is probably beneficial because it will help prohibit the economy from overheating. Equity markets should do well in anticipation of an end to the interest rate hikes.

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EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS

March 31, 2006

Assets

Equity in County's pooled cash and investments	\$ <u>380,663</u>
Investments	
Northern Trust	2,329,684,015
Aetna	10,697,332
Fidelity - Elected Officials Plan	<u>843,741</u>
Total investments	<u>2,341,225,088</u>
Contributions receivable	<u>4,159,896</u>
Total assets	<u>2,345,765,647</u>

Liabilities

Benefits payable and other liabilities	<u>2,689,618</u>
Net assets held in trust for pension benefits	\$ <u>2,343,076,029</u>

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**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS**
March 31, 2006

Additions	Quarter	Fiscal YTD
Contributions		
Employer	\$22,147,060	\$66,233,516
Members	<u>3,915,351</u>	<u>12,222,402</u>
Total contributions	<u>26,062,411</u>	<u>78,455,918</u>
Investment income	95,532,663	220,729,643
Less investment expenses	<u>1,933,922</u>	<u>5,733,829</u>
Net investment income	<u>93,598,741</u>	<u>214,995,814</u>
Total additions	<u>119,661,152</u>	<u>293,451,732</u>
Deductions		
Retiree benefits	29,294,912	86,533,227
Disability benefits	2,117,647	6,190,493
Survivor benefits	241,856	627,602
Refunds	88,072	388,703
Administrative expenses	<u>445,971</u>	<u>1,414,881</u>
Total deductions	<u>32,188,458</u>	<u>95,154,906</u>
Net increase	<u>87,472,694</u>	<u>198,296,826</u>
Net assets held in trust for pension benefits		
Beginning of period	<u>2,255,603,335</u>	<u>2,144,779,203</u>
End of period	<u>\$2,343,076,029</u>	<u>\$2,343,076,029</u>